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TAGS: EFIN ECON MX
SUBJECT: Monterrey: Ground Zero for Mexico's Emerging Venture Capital Industry

¶1. (U) Summary: To provide greater space for small and medium-sized companies, Monterrey Tec, Mexico's most prestigious private university, has established a private enterprise program which provides seed capital for start-ups. Teaming with Monterrey Tec and private industry, ConGen Monterrey is sponsoring the first-ever Mexico venture capital conference April 20-22 in Monterrey. With the planned conference, organizers seek to open up the next segment of the market: venture capital. The conference will bring together Mexico's leading entrepreneurs, innovators, captains of industry, investors, policymakers and economists to identify barriers, find solutions, and build an ecosystem that generates new technology and competitive high-growth companies. In business-oriented Monterrey, family-owned firms have traditionally dominated the landscape, with private equity playing a much smaller role. The April 20-22 event will provide participants with an idea of how venture capital can promote greater entrepreneurship and innovation, as well as the obstacles stunting its growth. Organizers welcome participation from USG agencies. End Summary.

Whither Mexico's Venture Capital?

¶2. (U) On December 16, 2009 the Americas Society/Council of the Americas hosted a panel discussion on the state of venture capital in Latin America. According to panelists, although sources of private equity (PE) and venture capital (VC) have dried up in developed country credit markets in the past year, the credit crisis has not affected the Latin American VC industry. Key countries in Latin America have well-regulated banking systems and minimal leverage and debt. Panelists commented that sound macroeconomic policies have allowed for organic small and medium sized enterprise (SME) development throughout much of the region. This, in turn, helps foster venture capital investment. That said, panelists concurred that the reason venture capital has held up in Latin America is that it starts from such a low base. Latin America represented just 1 percent of global Private Equity (PE)/Venture Capital (VC) fund-raising in 2008, and in 2007 PE represented just 0.23 percent of its GDP.

¶3. (U) Seminar speakers noted that, according to statistics from the Latin American Venture Capital Association (LAVCA), Mexico comes in second after Brazil in Latin America as a destination for VC investment. After discounting for the relatively large size of its economy, Mexico is underserved in terms of VC compared to other key countries in Latin America; in 2008 it accounted for a mere 15 percent of investments in the region as compared to 55 percent for Brazil.

VC Growth in Mexico Stymied

¶4. (SBU) Alonso Bustamante Guerra, Senior Analyst of Ignia, a Monterrey-based social venture capital firm, recently told EconOff that Mexico has a robust social VC climate, but regulatory restrictions have stunted the industry as a whole. He estimated that there are currently less than 10 formal VC funds operating in Mexico. Not all VC funds have achieved success and many shut down in the past year. However, interest from investors remains high. Ignia has received significant investments from the Inter-American Development Bank, Fondos de Fondos, Soros Economic Development Fund, OMIDYAR, and, most recently, and as yet unannounced, the IFC/World Bank. (Note: Social venture capital is a form of

venture capital investing that provides capital to businesses deemed socially and environmentally responsible. End note.)

¶5. (SBU) The Fondos de Fondos (Fund of Funds), Mexico's sole provider of seed capital to SMEs, was established in 2006 by GoM-affiliated development banks across Mexico - NAFINSA, BANCOMEXT, BANOBRAS, and FOCIR - to serve as an economic policy instrument specializing in the PE and VC markets to promote SME development. According to Bustamante, the fund currently lacks the direction or experience to guide development of a viable VC industry.

¶6. (SBU) Rogelio de los Santos, venture partner of Monterrey-based AltaVentures Investment, noted that as venture capital is a high-risk endeavor, it is a very new concept in Mexico and there is not a lot of capital available for this type of investment. However, he added that Mexico does have certain advantages, including its well-developed consumer market, its geographic proximity to the U.S., and it's relatively low cost of labor, goods, and services. Moreover, Mexico has an advanced university system, numerous R&D initiatives, and regional technological clusters. (Note: AltaVentures, formed in 2009, is a member of the Monterrey Venture Capital Conference organizing committee. End note.)

Obstacles -- Capital Formation

¶7. (U) While there appear to be significant opportunities and growth potential in Mexico for VC markets, there are several obstacles. Most entrepreneurs and SMEs obtain capital from family and friends. Larger more established and less risky enterprises receive capital from investors seeking lower risk investments. However, local entrepreneurs have limited access to local capital markets because of the high-risk nature inherent in start-up financing. Moreover, only since 2005 has the GOM allowed pension funds such as AFORES to invest in the Mexican Stock Exchange (BMV) and the GOM did not allow them to invest in VC/PE until mid-2009. In addition, private pension funds lack the size and experience to invest in these markets. Many foreign-owned insurance companies operating in Mexico are unfamiliar with Mexican insurance investment regulations and have forgone local investment

opportunities.

Obstacles -- Regulatory Environment, Lack of Effective Corporate Governance

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¶8. (SBU) Mexico's inflexible regulatory environment has hobbled the growth of the VC industry. Potential investors view the Mexican legal system as slow, unreliable, and volatile. A sizeable number of Mexican entrepreneurs and companies, many family-owned, lack the corporate governance capacity or training to gauge performance levels, assess risk, gauge global competitiveness, or provide for a going concern. Many lack formal boards that include external/independent members, do not have audit committees, board approved succession plans, and are unfamiliar with measures to protect minority investor rights.

¶9. (SBU) The overwhelming majority of companies are still in

noncompliance with the Mexican Stock Exchange Law (NLMV), approved in December 2005 to address investor concerns over corporate governance, and the GOM lacks the means to enforce the law. For example, prior to the NLMV, Mexican companies were legally obligated to confer pre-emptive rights to all stockholders, requiring them the right to purchase a a proportion equivalent to their current holdings of any new stock issued. This requirement, and its subsequent financial implications to shareholders, effectively kept Mexican companies from issuing future stock options, warrants, anti-dilution rights, and registration rights as equity.

¶10. (SBU) Another hindrance to investment relates to voting rights. Prior to passage of the NLMV stockholders could not legally agree to vote in a predetermined fashion, blocking minority members from voting as blocs to protect themselves from the majority stakeholders. Furthermore, Mexican law did not allow private companies to trade in their own stock unless legally required to do so to meet credit debts. Stockholders were also subject to retroactive liability and thus were legally responsible for the company's preexisting commitments. While the terms of the NLMV rectified these problems, its provisions are not being uniformly enforced.

Obstacles -- Lack of Fiscal Transparency

¶11. (U) Another obstacle to VC growth is Mexico's lack of a domestic investment conduit for the VC industry. As it is now, if an investment corporation conducts business in Mexico, it is taxed twice: both the fund and the individual investors. Mexican law does not allow the companies to act as a tax pass-through whereby taxes are only assessed to the fund owners. This lack of fiscal transparency is extremely costly to investors. To bypass this regulation, investors use offshore funds as investment vehicles. As U.S. Limited Liability Companies (LLC) are not accepted as fiscally transparent by Mexican law, investors have resorted to Canadian Limited Partnerships (LP) for investment purposes because Canada is considered fiscally transparent. (Additionally, Canada is not considered a tax haven and thus is not subject to a 40% tax on gross capital gains payable on share transfers.) However, this method of circumvention is still expensive as investors cannot have offices or a tax presence in Mexico unless they are willing to face steep tax liabilities, including an income tax on their worldwide earnings.

Steps Toward Reform -- Seed Capital and Angel Investors

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¶12. (U) Despite the obstacles, the culture of investment has been changing over the past decade. Angel investment clubs have gained a greater presence. These clubs join private investors who seek to diversify their portfolios, invest in entrepreneurs, and help support SMEs. Angel Ventures Mexico (AVM) and Investors Club Mexico (CIM) are among the growing crop of angel investment groups that have not only experienced success, but have been gaining worldwide attention as well. They are changing and supporting the entrepreneurial culture, even going so far as to hold angel investment 'classes' at local colleges.

¶13. (U) Universities such as Monterrey Tec have taken a more comprehensive approach in providing seed capital to entrepreneurs. Tec has established a private enterprise program which provides seed capital for start-ups. Meanwhile, Tec received funding from the Nuevo Leon State Secretary of the Economy to create a technological center for research and development. These facilities host start-ups in their endeavors. Approximately 30 percent of those supported are Tec students, while the remaining 70 percent are alumni or members of the community.

¶14. (SBU) Cesar Godinez Rodriguez, Director of Capital Funds and Vice-Rector of Investment and Technological Development at Tec estimated that of the start-ups since 2002 that have received seed capital, 80% remain in operation. Additionally, Tec helped develop 10 angel investment clubs throughout its campuses to connect private investors with start-ups. Each investor commits to a minimum investment of US$23.4 million, with no ceiling for the amount they can invest. Every entrepreneur submits a project idea. Tec then chooses the best technology and innovation projects and the start-ups are connected with the angel investment clubs. While Tec cannot monetarily benefit from the transactions, it benefits via promotion of its students and recognition of its leadership.

¶15. (U) As stated earlier, Monterrey Tec, private industry, and Post have collaborated to organize Mexico's first-ever venture capital conference to be held April 20-22 in Monterrey. For further information regarding the agenda and schedule for the 2010 Monterrey Venture Capital Conference, contact Monterrey Consul General Bruce Williamson (WilliamsonB@state.gov) or Econ/Pol Chief Tim Hall at (HallTO@state.gov).

¶16. (U) Embassy Mexico City has cleared this cable.
WILLIAMSON